THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 403 **JANUARY 2007**

Thus, the overall fragility-robustness of the financial structure, upon which the cyclical stability of the economy depends, emerges out of loans made by bankers. A cash-flow orientation by bankers is conducive to sustaining a robust financial structure. An emphasis by bankers on the collateral value and the expected values of assets is conducive to the emergence of a fragile financial structure.

— Hyman P. Minsky, *Stabilizing an Unstable Economy*, 1986

INFLATE OR DIE

With some consternation, we have been reading that Fed officials think the U.S. economy is a lot sounder today than it was at the end of 2000 and in early 2001, when the Fed abruptly reversed course and began a string of rapid interest rate cuts. One can only wonder about its reasoning. What we see is a doubling of the U.S. trade deficit, the complete collapse of personal and national saving and an unprecedented borrowing deluge that created the most anemic GDP growth in the whole postwar period.

During the five years 1995–2000, nonfinancial debt growth by 32.4% went together with 22.2% real GDP growth. In the following five years 2000–05, nonfinancial debt grew by 47.3% and real GDP by 13.4%. There has been an atrocious deterioration in the relationship between debt growth and economic growth.

In his speech on the Economic Outlook on Nov. 28, Chairman Ben S. Bernanke said:

> *A reasonable projection is that economic growth will be modestly below trend in the near term but that, over the course of the coming year, it will return to a rate that is roughly in line with the growth rate of the economy's underlying productive capacity. This scenario envisions that consumer spending — supported by rising incomes and the recent decline in energy prices — will continue to grow near its trend rate, and that the drag on the economy from the motor vehicle and housing sectors will gradually diminish.*

To everybody's surprise, Mr. Bernanke indicated he was more afraid of inflation than of an economic slowdown. What, actually, would happen if he expressed some fears about an economic slowdown? He would unleash an undesirable torrent of speculation anticipating the coming rate cuts. It is one of the many bad ideas of Mr. Greenspan that central banks should foreshadow to the public their next policy moves. It only plays into the hands of speculators.

While admitting that *"the correction in the housing market could turn out to be more severe and widespread than seems most likely at present,"* Mr. Bernanke added:

> *Economic growth could rebound more vigorously than now expected. The solid rate of job growth, the decline in the unemployment rate and the healthy pace of capital investment could be signals that underlying fundamentals are stronger than generally recognized. Moreover, to date, there is little evidence that the weakness in housing markets is spilling over more broadly to consumer spending or aggregate employment. If these trends continue, growth in real activity might return to a pace that could intensify upward pressures on resource allocation.*

Pondering the U.S. economy's performance in 2007 ultimately boils down to two main questions: *first*, whether the housing downturn will seriously hurt consumer spending; and *second*, whether capital spending

by Corporate America will promptly come to the rescue when consumer spending slows.

In our view, the first eventuality is highly probable, and the second is highly improbable. The first of the two assumptions is simply commanded by the recognition that the housing bubble over the last few years has been the economy's main driving motor, against pronounced weakness in business capital investment. Sharply rising house prices provided the collateral, which enabled private households to embark on their greatest borrowing-and-spending binge of all time.

Those "wealth effects" from house price inflation, manifestly, played the key role in fueling the soaring home equity withdrawals. But the thing to see now is that to stop this easy credit source, it is enough for house prices to flatten. In fact, the curb to this borrowing-and-spending binge has started with a vengeance.

A SLUMP IN MORTGAGE BORROWING

The fact is that private households have drastically curbed their mortgage borrowing. It amounted to $672.7 billion in the third quarter 2006, sharply down from $1,223.6 billion in the same quarter of last year. That is, consumer borrowing almost halved. It amazes us how little attention this fact finds.

It means that the most important credit source for spending in the economy is rapidly drying up, even though money and credit remain, in general, as loose as ever. It is drying up because the decisive lever of this borrowing binge, rising house prices, has broken down; most importantly, this lever is not under the control of the Federal Reserve.

A sharp decline or even cessation of such borrowing essentially indicates an impending sharp retrenchment in consumer spending. Mortgage equity withdrawal peaked at an annual rate of about $730 billion, or 8.1% of GDP, in the third quarter 2005. One year later, in the third quarter 2006, it was sharply down to $214 billion.

This, too, represents a pretty steep decline. Yet it seems to have had little effect on consumer spending, which rose 3.9% in 2004, 3.5% in 2005 and 2.9% in the third quarter of 2006. For the bullish consensus, this is instant proof of its prior assumption that the downturn in the housing market will not spill over more broadly to consumer spending or aggregate employment. The truth is that consumer spending has been squarely hit.

But to realize this, it is necessary to look at total spending by the consumer on consumption and residential investment. The latter was down 11.1% in the second quarter and 18% in the third quarter 2006, both at annual rate. Combined, the two components of consumer spending in the third quarter had slowed to an annual rate of 2%, the slowest growth rate since the past recession, against a 3.8% increase in 2005.

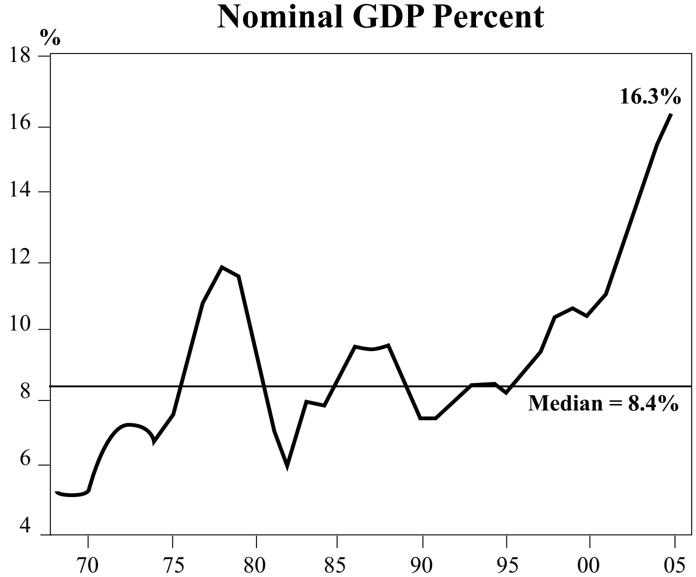
In 2005, real GDP rose $345.1 billion, or 3.2%. Private households increased their total spending by $312.2 billion, of which $264.1 billion was on consumption and $48.1 billion was on residential building. Together, the two components accounted for 91.8% of GDP growth. This spending boom compared with current income growth by just $93.8 billion, or 1.2%. Thus, less than one-third of the rise in consumer spending was funded by current income growth and more than two-thirds was derived from additional borrowing. To us, this seems an unsustainable pattern.

Considering the dramatic reversal in the housing bubble, a virtual collapse of consumer borrowing is definitely in the cards for the United States. Compensating for this big loss in spending power will require a sharp surge in employment and income growth. Some recent employment numbers have been somewhat better than expected. But they are not nearly as good as would be necessary to offset the impending further sharp decline in consumer borrowing. Importantly, there is no acceleration in comparison with last year.

The median price of a new single-family home fell 9.7% year over year in September — the largest percentage decline since December 1970. The median price of an existing single-family home fell 2.5% year over year — the largest decline in the history of the series.

How likely is it that this housing downturn will be milder than average, as the consensus assumes? A rule of thumb says that the fierceness of a downturn tends to be rather proportionate to that of the prior upturn. By any measure, this was America's wildest housing boom. We owe the following chart to Paul Kasriel of Northern Trust. It measures the dollar volume of single-family home sales to GDP. In 2005, it reached a record high of 16.3%, almost double the median percentage of the entire series dating back to 1968.

Dollar Volume of Single-Family Home Sales*/ Nominal GDP Percent



*** combined new and existing home sales**

Source: Northern Trust Global Economic Research

For us, the most obvious, and also most simple, measure of spending excess is associated increases in credit and debt. Between 2000 and third quarter 2006, the mortgage debt of U.S. private households soared from $4,801.7 billion to $9,497.4 billion. In barely six years, it has, thus, almost doubled.

We have been reading with utter amazement that stronger employment and income growth will offset the negative effects of the downturn in homebuilding. By available official numbers, the housing bubble — including directly related businesses such as furniture, mortgage finance and real estate — has created about 850,000 new jobs, about 30% of total job growth. Most of these jobs are sure to disappear.

BORROWED VS. EARNED LIQUITY

One argument certainly plays a prominent role behind the widespread denial that the housing downturn might drive the U.S. economy into recession, and that is the perception of overabundant liquidity sloshing around in the United States and the world at large.

Can there be a serious economic downturn with so much liquidity around? In short, there can. The U.S. economy and its financial system were drowning in liquidity when the stock market and the economy collapsed in the late 1920s and the early 1930s, and so was Japan's economy in the early 1990s when the markets there began their collapse.

Please recall Minsky: *"An emphasis by bankers on the collateral value and the expected value of assets is conducive to the emergence of a fragile financial structure."* It is typical of bubble economies that rising asset values dominate borrowing and spending in the economy. Measured by its level of indebtedness, today's U.S. economy is the worst bubble economy in history.

History tells us that every major economic and financial crisis has had two main causes. Excessive credit is one, and excessive optimism is the other. Both exist in unusual abundance in the United States today.

Available liquidity is, of course, most important. Nevertheless, we find it most important to distinguish, first of all, between two different sources of liquidity: *borrowed* and *earned* liquidity. Present excess liquidity in the United States and several other countries is of a peculiar kind.

It does not come, as would be normal, from unspent current income — in other words, from saving. In the absence of any new savings, all the liquidity creation occurring in the United States is *borrowed* liquidity, generally borrowed against rising asset prices, in diametric contrast to earned liquidity from savings out of

current income. By definition, this is liquidity from credit inflation.

One thing is certain about borrowed liquidity: It depends on rising asset prices. Once asset prices stop increasing (see current U.S. house prices), this "liquidity" suddenly evaporates. Moreover, ever larger credit injections are needed to keep asset inflation — like any other inflation — rising. Nevertheless, there inevitably comes a point at which asset prices for some reason or another refuse to rise further, and then the big selling without buyers begins. There has never before in history been an exception from this disastrous end of asset inflation.

Well, this counts for the long run. Unfortunately, it is never possible to predict when this starts. The U.S. economy, in particular its financial system, has proved to have a superior ability to drive financial leverage to unimaginable excess. However, this has required rapidly increasing accommodation by foreign central banks. In Germany or France, such asset and credit bubbles would have burst long ago. Then again, they would not have been possible in the first place.

The other day, we read with great awe in the *Financial Times* about the finances of a hedge fund, Citadel. It had paid more than $5.5 billion in interest, fees and other costs last year. This compared with a net asset value of only about $13 billion and gross assets of $166 billion at the end of August 2006, implying a leverage of 12.5 times. Costs are sky-high because its managers trade frequently and operate with huge leverage.

This pattern is most probably typical of the numerous existing hedge funds. Mr. Greenspan has repeatedly hailed that hedge funds, with their large turnover, improve the efficiency and the liquidity of the markets. This was certainly also true of Long-Term Capital Management before it burst. That a central banker uses these two criteria is utterly strange. His main concern about markets should definitely be that financial assets are properly priced in line with available savings.

It should be clear that the heavily leveraged asset purchases by hedge funds grossly distort asset pricing in the United States, among which the resulting artificially low long-term rates play the greatest role. A few years ago, Mr. Greenspan wondered publicly about the "conundrum" that U.S. long-term interest rates were falling while he was raising short-term rates. There never was a secret about the source of this "conundrum": persistent large bond purchases by foreign central banks, and, in addition, heavily leveraged bond purchases by hedge funds and financial institutions, funded by low-yielding currencies, above all yen carry trade.

Still, all this leaves us with the question of whether this system is sustainable forever. Our answer is a categorical no. As emphasized earlier, the decisive condition for a credit-driven asset bubble is the sustained expectation of rising asset prices, and this is flatly impossible. There inevitably comes a point at which even the wildest expectations are met and new asset purchases abate or cease.

Take the case of 10-year U.S. Treasury notes. They have declined to 4.55%, from 5.25% at their high for the year, on June 28. Including the capital gain, this gave investors in the period a return of 7.5%. From this yield, the leveraged speculators have to deduct their interest expenses. In the case of yen carry trade, they were minimal. But even when financed at an annual rate of 5.25% in dollars, this was highly lucrative when leveraged 10 times or more.

The obviously critical question here is when the speculators will liquidate their positions because they think that the interest rates of 10-year Treasury notes have hit their lowest possible point. We have no idea where that point is, but we know that it exists somewhere. Moreover, there is the looming risk of a falling dollar. A sharp slowdown of the U.S. economy, or even recession, would certainly trigger such a fall, as happened in 2003–04.

INDUSTRIAL CIRCULATION VS. FINANCIAL CIRCULATION

Assessing liquidity influences, we distinguish further between two separate kinds of money circulation. One is the money circulation equated to gross domestic product, which is the economy's entire output of goods and services. Spending in the economy involves employment and income growth.

The second category of money circulation takes place entirely outside the gross domestic product and corresponds to the national wealth. Its object is trading in existing assets of all kinds. Keynes distinguished between "industrial" circulation and "financial" circulation. But "industrial" also covers services. The key distinction is really between spending of money that creates employment and incomes, on the one hand, and spending of money that occurs in the markets outside the economy, mainly impacting asset prices.

Of course, there is no dam between the two markets. During the past few years, the housing bubble in the United States and several other countries exerted massive effects on consumer spending. But that is the exception that makes a "bubble economy." Such pronounced asset and credit bubbles emerged for the first time in the 1980s.

Over the past few years, though, conspicuous asset and credit bubbles are widespread around the world. To quote the study published by the Bank for International Settlements about its causes:

> *In recent years, when judged against traditional macroeconomic yardsticks, developments in global interest rates and measures of "liquidity" have been remarkable. It is hard to find a period in the postwar era in which inflation-adjusted interest rates have been so low for so long and monetary and credit aggregates have expanded so much without igniting inflation.*

It is no secret what actually happened. A rapidly growing part of the escalating credit expansion around the world went into asset markets, fueling inflation in asset prices. At the same time, inflation rates of goods and services are held down by globalization. Many American economists appear to regard this as the promised land of permanent Goldilocks growth.

A NEW GROWTH MODEL

We read that the world has stumbled into a new growth model in which rising asset prices act as the main drivers of economic growth. We vehemently disagree. This is wishful thinking, particular of American policymakers and economists, reflecting the hope that this is a sustainable pattern of economic growth. It is not for a simple reason: Asset values cannot rise to the sky.

What have developed in the past few years, primarily in the United States and China, are typical bubble economies, in which a credit bubble drives specific bubbles in spending. In the United States, unprecedented credit excess has propelled overconsumption and financial speculation, while in China, unprecedented credit excess has propelled overinvestment in business fixed investment and residential building.

The obvious main cause is the runaway credit creation in the United States after the 2001 recession. The Fed cut interests quickly and aggressively. Before the bursting high-tech bubble could do serious damage to the U.S. economy, the Greenspan Fed had managed to create the housing bubble. Rising property prices more than offset the negative effect of the plummeting Nasdaq on household wealth.

During 1995–2000, the personal savings rate had dropped from 4.6% to 2.4% of disposable income. Lately, it is more than 1% in negative territory. The trouble with the drastic monetary easing was that it went overwhelmingly into consumer spending and residential building, while business fixed investment suffered its steepest fall. Net investment in 2005 was down 50% from its level of 2000. As the economy's supply side drastically lagged, the resulting excess demand spilled over into the exploding trade deficit.

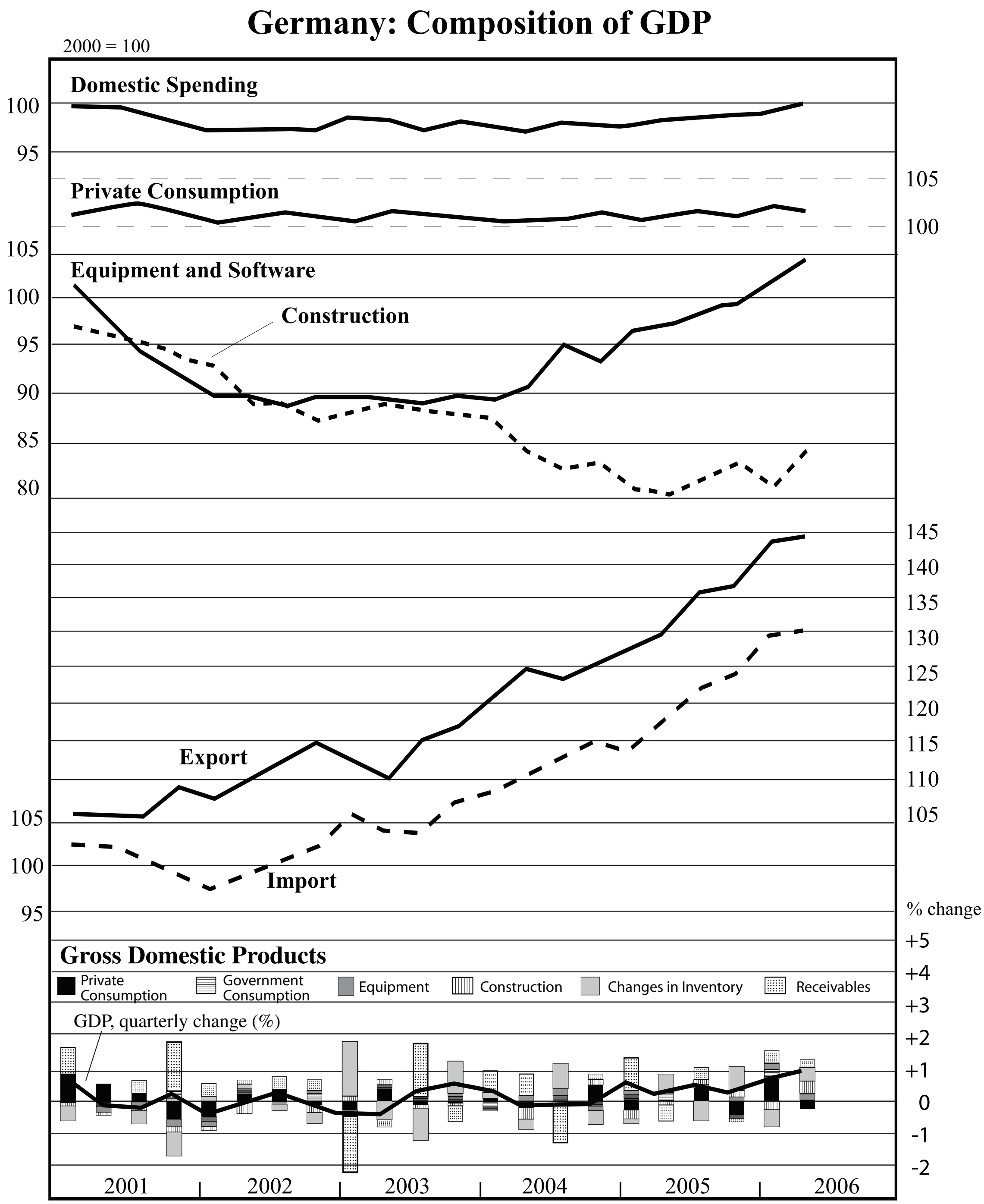
This deficit simply reflects the excess of expenditures in the United States relative to current income or production, while China's export surplus simply reflects the excess of current production over domestic expenditures.

The demand excess in the United States has taken its way increasingly toward China. In 2000, China's overall trade balance was a $34.4 billion surplus. Recently, the surplus has been running at an annual rate of more than $250 billion. If the Americans borrow to consume, the Chinese borrow to invest. Today, about half of the Chinese GDP is devoted to investment and net exports. Household consumption last year was 38% of

GDP. As a result of this investment boom, the economy's supply side keeps rising much faster than its demand side. This heavily lopsided resource allocation toward investment and exports is really the key problem.

EUROPE SURPRISES

All of a sudden, reports abound about how well the European, and in particular the German, economy is doing. As the Organisation for Economic Co-Operation and Development (OECD) noted in its latest *Economic Outlook*, the eurozone's GDP grew at a 3.5% annual rate in the first half of 2000, more than twice the pace of the year before. For the third quarter, the growth rate is estimated at 3.2%.

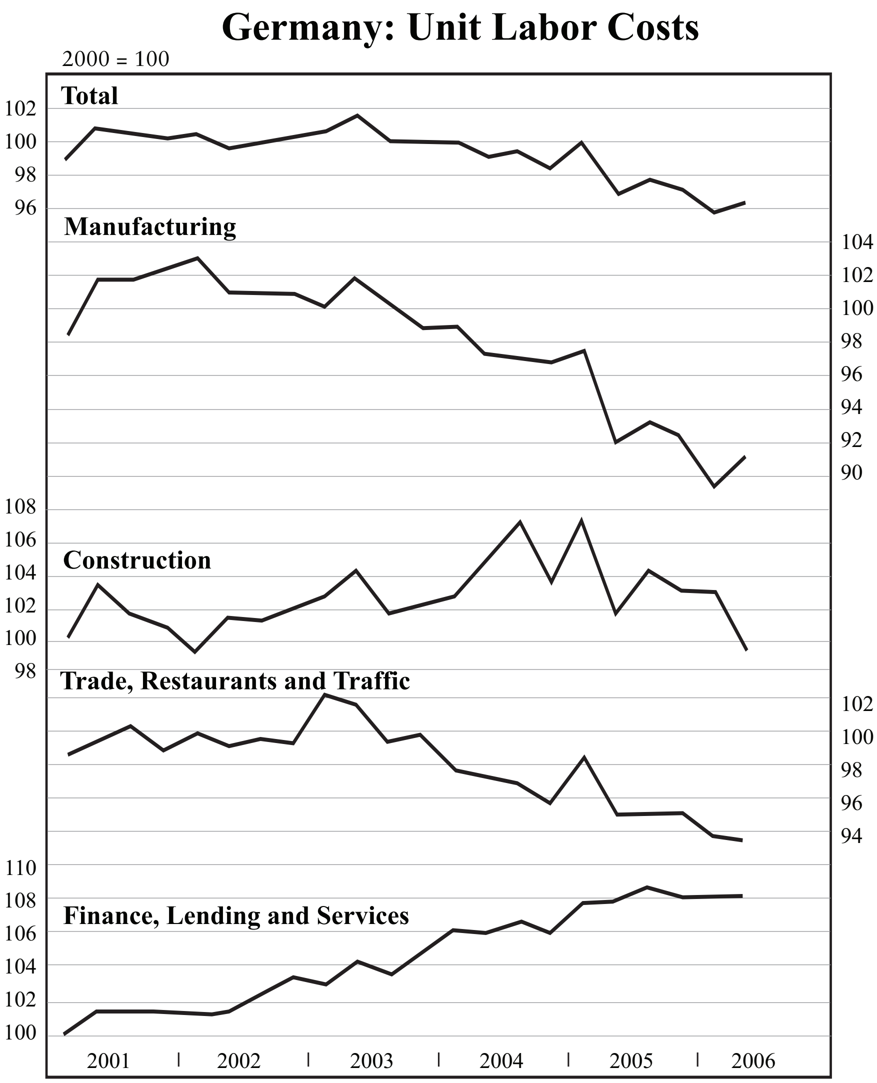


Source: Deutsche Bundesbank

Behind this recovery is that of its biggest member, Germany, accounting for close to 30% of the eurozone's economy. Over the five years 2000–05, German real GDP increased barely 3%, less than 1% per year, and this owed completely to rising exports. Domestic demand in 2005 was no higher than in 2000.

What has happened to create this German surprise? It is mainly two changes: an apparent end to the protracted decline in construction and a roaring export boom. Overall building, residential and nonresidential, in 2005 was down 18% from its level in 2000. After a downturn that lasted more than 10 years, in 2006, building staged its first slight recovery. The long slide in building was a legacy of reunification, which had unleashed a prolonged building boom.

Germany's recovery is unambiguously driven by an escalating export surplus. It has soared from €59.1 billion in 2000 to €160.5 billion in 2005. Simultaneously, the current account went from a deficit of €35.2 billion to a surplus of €92.6 billion. This swing in the current account over these years was equivalent to 5.6% of the German 2005 GDP. Exports were up 33.2% and imports were up 19.8%.



Source: Deutsche Bundesbank

This compares with an overall increase in domestic spending during the same four years as follows: private consumption, +1.1%; government spending, +1.8%; business fixed investment, –1.5%; and building, –18%. To emphasize, these figures apply for the whole period. The personal savings rate rose from a little over 9% to a little over 10% of disposable personal income.

In short, confronted with complete stagnation of domestic demand, the manufacturing sector switched to exports with a vengeance. At the same time, firms boosted their productivity. Over the six years to 2006, output per hour in the sector soared by 25%. As wages per hour increased 13%, unit labor costs fell slightly more than 10%. In the economy as a whole, productivity growth by 8% per hour was matched by an increase in labor costs per hour of an equal percentage. Business profits have been rocketing.

Consumer prices increased over the six years by 10% including energy, and by 8% without it. Core price inflation averaged a little more than 1.3% per year. Including energy, its annual increase averaged almost 1.7%.

Actually, Germany is the country in the eurozone that, with its huge export surplus, is keeping the whole area's current account in balance. In 2005, the area scored a net current account deficit of €23.1 billion with outside countries, as imports had been accelerating in relation to exports. A main reason was the soaring oil

price. Several countries have been running up large deficits — in order of magnitude: Spain, France, Italy, Greece and Portugal. One has to wonder in particular about the tremendous difference in trade performance between France and Germany.

The article "Sick Man Is Picture of Health" in the *Financial Times* nicely summed up the development in Germany:

> *Despite the apocalyptic predictions being heard across Europe about the economic threat from China and India, the German Mittelstand, the small and midsized manufacturers that make up the backbone of the country's economy, have emerged as the biggest European winners from globalisation.*
>
> *For the third year running, Germany is on course to be the world's largest exporter of goods this year, and its companies will generate the third highest number of patents every year.*
>
> *The German disease of mass unemployment is also on retreat. Companies have created about 500,000 jobs since January, bringing the unemployment rate below the 10% mark in October for the first time in four years. Many businesses are struggling to fill their vacancies.*
>
> *Public finances have improved beyond all expectations. Boosted by rising tax revenues, the government will this year bring the public sector debt back in line with the E.U.'s fiscal rules, one year ahead of schedule. Peer Steinbrück, finance minister, hopes to balance the budget by 2010. More surprising still, Germany's lavish social security system generated an €8.5 billion surplus in the first half of the year, after a €7.1 billion deficit a year earlier.*

The missing link in the European and the German recovery story remains consumption. And also do not forget that the European countries, despite the very slow economic growth, have completely abstained from any fiscal stimulus. Both government revenues and expenditure as a share of GDP are virtually at the same level today as in 2000.

In contrast to their counterparts in the United States, private households in the eurozone have adjusted their spending to the virtual stagnation of their real incomes. In the aggregate, gross savings remained broadly stable at levels close to 15% of disposable incomes, of which about 5 percentage points accounted for housing and around 10 percentage points for the acquisition of financial assets.

Aggregate debts of private households in 2004 stood a little over 90% of gross disposable income, up from 82% in 1999. As interest rates declined, the ratio of interest payable to gross disposable income receded over the same period from 3.2% to 2.6%. In Italy, private households debts are 40% of GDP.

It has become the conventional view that Europe owes its slow growth mainly to rigidities, in particular in its labor market. In our view, this argument is vastly overrated. In the same vein, it is foolish to attribute the U.S. economy's superior growth performance largely to greater flexibility in this respect. The higher U.S. economic growth during the past few years has a variety of obvious reasons.

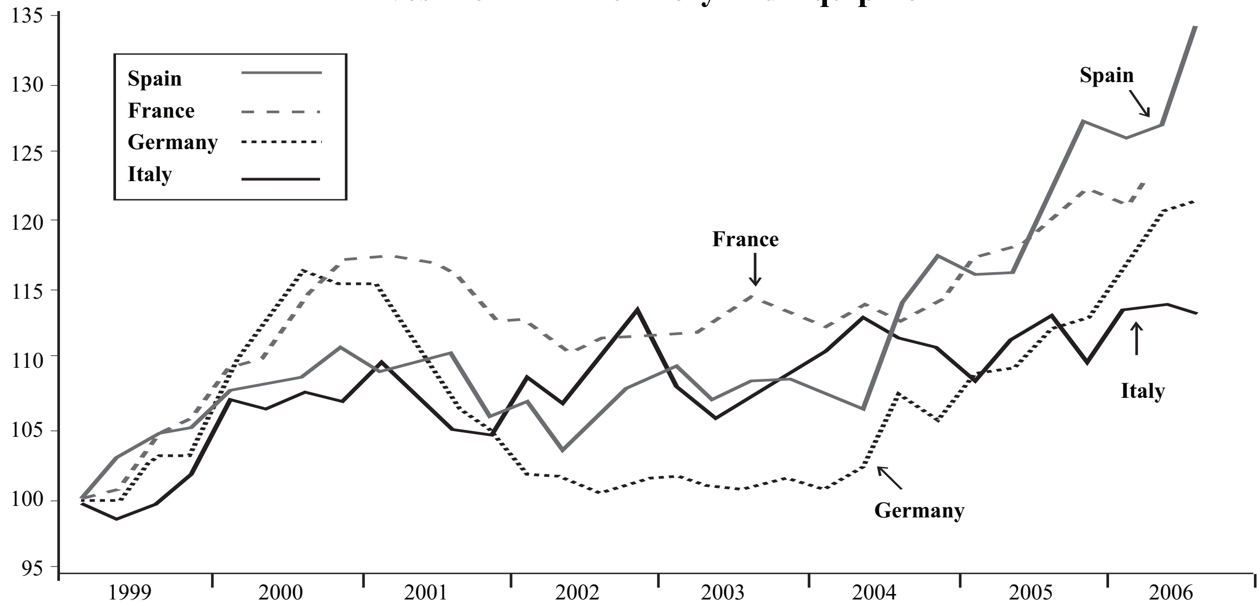
First, we would mention higher population and labor force growth in the United States accounting for an annual difference of 1%. *Second*, there was far more monetary and fiscal stimulus in the United States. *Third*, the U.S. economy is incomparably more addicted to credit and debt growth than the European economy. But the single most important difference between the two areas during the past few years has been in consumer spending and personal saving.

Consider that the U.S. recovery from the 2001 recession had its main propellant in the housing bubble and the associated consumer borrowing-and-spending binge, as reflected in the savings collapse. It has worked for the time being. Nevertheless, it ought to have been clear right from the beginning that this pattern of economic growth is unsustainable and that for the economy to gain sufficient traction would require much stronger income creation from business fixed investment. The question to ask and to examine is whether or

not this is happening. Later, we shall give and explain our answer.

In the interim, a few more remarks about the eurozone economy. The main driving forces behind the favorable development of economic activity in 2006 have been strong growth rates for both construction and nonconstruction investment, each of which accounts for roughly half of total investment. Construction has definitely been on the stronger side. Yet investment in machinery and equipment started a sharp acceleration across the eurozone in 2004, after virtual stagnation since 2000.

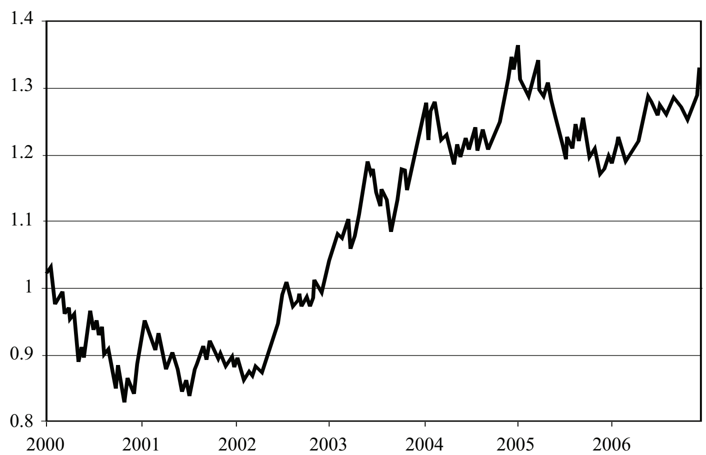
Investment in Machinery and Equipment



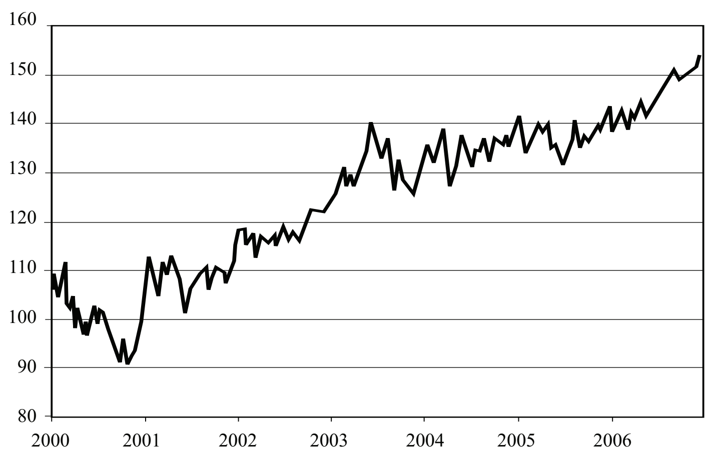
Source: Thomson Financial Datastream

What also strikes us as particularly interesting are the significant differences in the inflation rates between Europe and the United States. The year-over-year rate of consumer price inflation in the United States has hit a peak of 4.3% in June 2006. Its simultaneous peak in the eurozone was 2.5%. More recently, the U.S. rate was down to 2%. But in Europe, this so-called headline figure has declined 1.6%. This sharp drop was mainly due to the development in energy prices. So-called core inflation in Europe is recently at 1.5%. Drawing this comparison, we have to add that we regard U.S. inflation rates as grossly understated, mainly due to excessive hedonic pricing.

Euro to Dollars



Euro to Yen



There is one obvious main reason for this major difference in inflation performance. That is the euro's steep revaluation against the dollar from its low of 84 cents in 2002. Trading now at around $1.32, this marks a decline of the dollar by a stunning 57% over just four years. As inflation has been most rampant in oil and commodity prices, quoted in dollars, this drastically lowered their impact on producer costs and prices in Europe.

REVISITED: U.S. MONETARY ANARCHY

Recently, the European Central Bank staged a conference under the title *The Role of Money: Money and Monetary Policy in the 21st Century.* Presenters included Federal Reserve Chairman Bernanke, ECB President Jean-Claude Trichet and ECB Vice President Lucas Papademos.

Unfortunately, the discussion of money is often too technical in nature and almost always insufficiently accessible even to economists not specialized in monetary matters. This is most unfortunate, and the scholarly presentations in this conference — at least those that we read — are typical in this regard. Still, one thing has clearly emerged from this conference. The old school ECB remains firmly committed to monetary analysis, while the New Age Fed has abdicated the monetary aggregates and, in this process, carelessly tossed monetary analysis into the dustbin.

Mr. Bernanke started his speech with the remark, *"My topic today is the role of monetary aggregates in economic analysis and monetary policymaking at the Federal Reserve. I will take a historical perspective, which will set the stage for a brief discussion of recent practice."*

He then used most of his time to explain that the former close relationship between the growth of money and the growth in nominal aggregates in the economy and inflation in the United States since the 1980s had successively broken down. He specifically mentioned that the Volcker Reserve had discontinued the procedure of targeting nonborrowed bank reserves in 1982.

A second episode he mentioned is that in the early 1990s, M2 grew much more slowly than the models predicted, to be followed by the remark: *"Experiences like this one led the FOMC to discontinue setting target ranges for M2 and other aggregates after the statutory requirement for reporting such ranges lapsed in 2000."*

Finally, he offered an explanation: the rapid pace of financial innovation:

> *As I have already suggested, the rapid pace of financial innovation in the United States has been an important reason for the instability of the relationships between monetary aggregates and other macroeconomic variables. In response to regulatory changes and technological process, U.S. banks have created new kinds of accounts and added features to existing accounts… As a result, patterns of usage of different types of transactions accounts have at times shifted rapidly and unpredictably.*

Financial innovations and deregulations have certainly played some role in distorting the monetary aggregates. This would definitely have strongly suggested maintaining M3 as the widest money aggregate. But apparently, the Fed regarded its persistent high rates of expansion as too embarrassing. With the ridiculous argument to save costs, it suppressed its publication.

THE BIG SHIFT IN INFLATION

A study recently published by the Bank for International Settlements *(Monetary and Prudential Policies at a Crossroad?)* says:

> *Financial liberalization is undoubtedly critical for the better allocation of resources and long-term growth. The serious costs of financial repression around the world have been well documented. But financial liberalization has also greatly facilitated the access to credit… more than just metaphorically. We have shifted from a cash flow-constrained to an asset-backed economy.*

Though we basically agree with the analysis and the conclusions of the study, we radically disagree with the one sentence that *"Financial liberalization is undoubtedly critical for the better allocation of resources and long-term growth."* The indispensable first condition for proper resource allocation at a national as well as global scale is avoidance of excessive money and credit creation. In many countries, and in particular in the United States, they are excessive as never before.

If Mr. Bernanke complains about irregularities of M2, this is nothing in comparison with the fact that credit and debt growth in the United States has exploded for more than two decades. When Mr. Greenspan took over at the helm of the Fed in 1987, outstanding debt in the United States totaled $10.5 billion. In less than 20 years, this sum has quadrupled to $41.9 billion. In reality, this significantly understates the rise in debts because, for example, highly leveraged hedge funds with trillions of outstanding debts are not captured. In 1987, indebtedness was equivalent to 223% of GDP, which was already pretty high. Lately, it is up to 317% of GDP.

In actual fact, there used to be a very stable relationship between money or credit growth and GDP or income growth until the early 1980s. Growth of aggregate outstanding indebtedness of all nonfinancial borrowers — private households, businesses and government — had narrowly hovered around $1.40 for each $1 of the economy's gross national product. Debt growth of the financial sector was minimal.

The breakdown of this relationship started in the early 1980s. Financial liberalization and innovation certainly played a role. But the most important change definitely occurred in the link between money and credit growth to asset markets. Money and credit began to pour into asset markets, boosting their prices, while the traditional inflation rates of goods and services declined. The worst case of this kind at the time was, of course, Japan.

Do not be fooled by the sharp decline in consumer borrowing into the belief that money and credit has been tightened in the United States. Instead, borrowing for leveraged securities purchases (in particular, carry trade and merger and acquisition financings) has been outright rocketing, with security brokers and dealers playing a key role. Over the three quarters of 2006, their net acquisitions of financial assets have been running at an annual rate of more than $600 billion, more than double their expansion in the past.

Federal funds and repurchase agreements expanded in the third quarter at an annual rate of $606.3 billion, or an annual 26%. The main borrowers were brokers and dealers. During the first three quarters of the year, their assets increased $427 billion, or 27% annualized, to $2.57 billion. A large part of the money came from the highly liquid corporations. There is no reason to wonder about low and falling long-term interest rates.

All this confirms that financial conditions remain extraordinarily loose. Even that is a gross understatement. Credit for financial speculation is available at liberty. Expectations for weaker economic activity only foster greater financial sector leverage. Why such unusually aggressive speculative expansion in the face of a slowing economy?

The apparent explanation is that the financial sector intends to make the greatest possible profit from the coming decline of interest rates, promising further rises in asset prices against falling interest rates. While the real economy slows, the leveraged speculation by the financial fraternity goes into overdrive. Principally, there is nothing new about such speculation. New, however, is its exorbitant scale.

GLOBALIZATION AT FAULT

Before leading his jumbo-sized delegation to Beijing, Henry Paulson, U.S. Treasury secretary, cautioned against expecting any big breakthroughs from the visit. And so it has turned out. The meeting produced plenty of statements about the desirability of improving relations, but nothing concrete to do so.

Of course, the Chinese are in a very strong position with the central bank holding more than $1 trillion of bonds in its portfolio, mostly denominated in dollars. According to reports, the American visit was initiated by Mr. Paulson in an effort to contain rising Sinophobia in the U.S. Congress, which increasingly blames China for America's economic problems, from its huge current account deficit to stagnating real incomes. In other words, those troublemakers, not the trade deficit, are the problem.

One cannot say that U.S. policymakers and economists have been preoccupied with worries about possible harmful effects of the exploding trade deficit. They appear obsessed with the conventional wisdom that free trade is good and must always be good under any and all circumstances, as postulated in the early 19th century by David Ricardo.

Ricardo exemplified this by comparing trade in wine and cloth between Portugal and England. Portugal was cheaper in both products, but its comparative advantage was greater in wine. As a result, according to Ricardo, Portugal boosted its production and exports of wine. In contrast, England gave up its wine production and could produce more sophisticated goods. In both countries, living standards rose.

For sure, it appears highly plausible that American policymakers feel they are following Ricardo's logic. Only they are disregarding some caveats of Ricardo's. For equal benefit, first of all, balanced foreign trade is required. *"Exports pay for imports"* was a dogma of classical economic theory. Ricardo, furthermore, disapproved of foreign investment, with the argument that it slows down the home economy.

With an annual current account deficit of more than $800 billion, the U.S. economy is definitely a big loser in foreign trade. To offset this loss of domestic spending and income, alternative additional demand creation is needed. Essentially, all job losses are in high-wage manufacturing, and most gains are in low-wage services. In essence, the U.S. economy is restructuring downward, while the Chinese economy is restructuring upward.

Considering that Chinese wages are just a fraction of U.S. or European wages, it appears absurd that the Chinese authorities deem it necessary to additionally subsidize their booming exports by a grossly undervalued currency, held down by pegging the yuan to the dollar.

CONCLUSIONS:

In the U.S. financial sphere, the year 2006 has set new records everywhere: records in stock prices, records in mergers and acquisitions, records in private equity deals, record-low spreads, record-low volatility. Manifestly, there is not the slightest check on borrowing for financial speculation. There is epic inflation in Wall Street profits.

One wonders what can stop this unprecedented speculative binge. Pondering this question, we note in the first place that the gains in asset prices — look at equities, commodities and bonds — have been rather moderate. To make super-sized profits, immense leverage is needed. We think the speculation is unmatched for its scope, intensity and peril. Plainly, it assumes absence of any serious risk in the financial system and the economy. The surest thing to predict is that the next interest move by the Fed will be downward.

In our view, the obvious major risk for speculation is in the economy — that is, in the impending bust of the gigantic housing bubble. Homeownership is broadly spread among the population, in contrast to owning stocks. So the breaking of the housing bubble will hurt the American people far more than did the collapse in stock prices in 2000–02. For sure, the U.S. economy is incomparably more vulnerable than in 2001. Another big risk is in the dollar.

THE RICHEBÄCHER LETTER

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